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The CitX Decision: Has the Tort of Deepening Insolvency Gone Bankrupt

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Issues in the Third Circuit

THE *CITX* DECISION: HAS THE TORT OF "DEEPENING INSOLVENCY" GONE BANKRUPT?

I. INTRODUCTION

In times of financial crisis, a corporation's board of directors often faces the complex question of how to maximize asset value for all stakeholders and must frequently decide whether to prevent seemingly irreversible losses by liquidating assets or whether to try to preserve the corporate entity by incurring more debt.[1] Deepening insolvency is a cause of action based on the underlying premise that, at some point, it is more beneficial for a corporation to cease operations, liquidate its assets and distribute the proceeds to creditors rather than continue to operate and incur unnecessary additional debt.[2] If a board of directors continues to operate beyond the point when it arguably should have liquidated, some courts, recognizing that such action gives rise to cognizable harm, allow stakeholders to

1. *See, e.g.*, John H. Rapisardi, *Third Circuit Revisits "Deepening Insolvency Theory,"* N.Y.L.J., July 20, 2006, at 3 (noting one choice that corporate management must make when facing insolvency is whether to liquidate assets or to incur additional debt). Insolvency typically is defined as a "financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation exclusive of [exempt property]." *See* 11 U.S.C. § 101(32)(A)(ii)(2001). A generally accepted definition of stakeholder is "any group or individual who can affect or is affected by the achievement of the organization's objectives." *See* Benedict Sheehy, *Scrooge—the Reluctant Shareholder: Theoretical Problems in the Shareholder-Stakeholder Debate*, 14 U. MIAMI BUS. L. REV. 193, 198 (2005) (quoting R. EDWARD FREEMAN, STRATEGIC MANAGEMENT: A STAKEHOLDER APPROACH 46 (1984)) (defining stakeholder).

2. *See* Schacht v. Brown, 711 F.2d 1343, 1350 (7th Cir. 1983) (discussing methods by which corporations can maximize value for shareholders). The Third Circuit has defined deepening insolvency as "an injury to the Debtor's corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life." *See* Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 350 (3d Cir. 2001) (defining deepening insolvency). For a complete discussion of the court's holding in *Lafferty*, see *infra* notes 28-41 and accompanying text. One commentator has characterized a typical deepening insolvency case as one in which "an insolvent corporation's trustee, receiver, or creditors' committee, standing legally in the insolvent corporation's shoes, sue the corporation's insiders and its deep-pocket outside professionals alleging that the defendants injured the corporation through wrongdoing that caused the corporation to incur unpayable debt that deepened the corporation's insolvency." *See* J.B. Heaton, *Deepening Insolvency*, 30 J. CORP. L. 465, 465-66 (2005) (detailing components of deepening insolvency claim).

sue the board and other corporate insiders (e.g., auditors, lawyers, underwriters and even lenders) for the tort of deepening insolvency.[3]

As one might imagine, judicial acceptance of this tort has incited vociferous debate over the prudence of circumventing the business judgment rule and placing liability for this insolvency directly on corporate management.[4] Some commentators argue that courts have increased the likelihood that a corporation's board of directors, fearing liability, will choose to liquidate its assets as opposed to making a good faith effort to resuscitate a company approaching financial crisis.[5] Stakeholders assert, however, that the tort of deepening insolvency merely ensures that corporate management makes fiscally responsible business decisions that maximize value.[6]

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3. *See, e.g.*, *Lafferty*, 267 F.3d at 347 (holding that creditors can sue for deepening corporations' insolvency); *see also, e.g.*, OHC Liquidation Trust v. Credit Suisse First Boston (*In re* Oakwood Homes Corp.), 340 B.R. 510, 530-31 (Bankr. D. Del. 2006) (stating that Delaware, New York and North Carolina would recognize deepening insolvency causes of action); Stanziale v. Pepper Hamilton LLP, (*In re* Student Fin. Corp.), 335 B.R. 539, 548 (Bankr. D. Del. 2005) (upholding deepening insolvency); Miller v. Dutil (*In re* Total Containment, Inc.), 335 B.R. 589, 619 (Bankr. E.D. Pa. 2005) (same); *In re* LTV Steel Co., 333 B.R. 397, 422 (Bankr. N.D. Ohio 2005) (discussing growing acceptance of deepening insolvency); Official Comm. of Unsecured Creditors v. Credit Suisse First Boston (*In re* Exide Techs., Inc.), 299 B.R. 732, 752 (Bankr. D. Del. 2003) (recognizing deepening insolvency as independent cause of action).

4. *Compare* Jay Bender, *Deepening Insolvency in Alabama: Is it a Tort, a Damages Theory or Neither of the Above?*, 66 ALA. LAW. 190, 194 (2005) (recognizing that corporations are under no duty to liquidate when faced with insolvency, and therefore business judgment rule protects corporate management from liability within zone of insolvency), Douglas Richmond, Rebecca Lamberth & Ambreen Delawalla, *Lawyer Liability and the Vortex of Deepening Insolvency*, 51 ST. LOUIS U. L.J. 127, 156-57 (2006) (noting that business judgment rule allows corporate management to take risks necessary to maximize profit), *and* Sabin Willett, *The Shallows of Deepening Insolvency*, 60 BUS. LAW. 549, 561 (2005) (concluding that business judgment rule should foreclose most actions for deepening insolvency), *with* Susan Gummow, *Director and Officer Liability Insurance: How Bankruptcy Transforms the Rights of the Various Parties*, 14 J. BANKR. L. & PRAC. 6, 15 (2005) ("[T]he protections of the business judgment rule may not fully apply once the corporation is in the zone of insolvency."). The business judgment rule effectively immunizes corporate management from liability when it has acted on "an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company." *See* Daniel E. Harrell, Comment, *Pandora's Bankruptcy Tort: The Potential for Circumvention of the Business Judgment Rule Through the Tort Theory of Deepening Insolvency*, 36 CUMB. L. REV. 151, 168 (2005-06) (citing Aronson v. Lewis, 473 A.2d 802, 812 (Del. 1984)) (providing practical effects of business judgment rule). For a discussion of the effects of the business judgment rule on corporate liability and corporate governance, see *infra* notes 56, 76, 118-23 and accompanying text.

5. *See* Harrell, *supra* note 4, at 152-54 (noting that extending deepening insolvency to claims of negligence "could provide a cause of action distinct from a breach of fiduciary duty claim, [and] officers and directors would be unable to rely on the protection of the business judgment rule," which in turn would make it far more likely that directors would liquidate when confronted with insolvency).

6. *See* Michael Bernstein & Charles Malloy, *Deepening Insolvency: An Emerging Theory of Liability*, 1 BLOOMBERG CORP. LAW. J. 406, 415 (2006), *available at* http://

Although coined over twenty years ago, there is a distinct lack of consensus among courts regarding the amorphous tort of deepening insolvency.[7] Questions remain as to whether deepening insolvency is in fact an independent cause of action or a measure of damages and whether negligence alone suffices to establish liability for such claims.[8] The Third Circuit has largely been at the forefront of these issues, and in two recent cases, has both vastly expanded and severely narrowed the tort of deepening insolvency.[9] In *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co.*,[10] the Third Circuit boldly established the tort of deepening insolvency as an independent cause of action.[11] Then, five years later, as a reaction to various misinterpretations of the *Lafferty* holding, the court clarified its

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www.arnoldporter.com/pubs/files/Deepeing_Insolvency.pdf ("To a cynic (or a defendant) [deepening insolvency] is unfair Monday-morning quarterbacking. To a plaintiff, it is simply a way of requiring that parties who have influence over the debtor make business decisions that are reasonably calculated to maximize value, even if value is maximized through liquidation.").

7. Certain courts have treated deepening insolvency as an independent cause of action, while others have treated deepening insolvency simply as a theory of damages. *Compare Lafferty*, 267 F.3d at 349-52 (holding that expansion of corporate debt can cause injury to debtor's corporate property that is actionable on independent basis of deepening insolvency), *and Exide*, 299 B.R. at 752 (recognizing deepening insolvency as independent cause of action), *with* Hannover Corp. of Am. v. Beckner, 211 B.R. 849, 854 (Bankr. M.D. La. 1997) (recognizing deepening insolvency as method of calculating corporation's damages, which include amount of indebtedness incurred from prolonging life of insolvent business), *and* Allard v. Arthur Andersen & Co., 924 F. Supp. 488, 494 (S.D.N.Y. 1996) (indicating deepening insolvency is theory of damages). Still other courts have rejected deepening insolvency as a theory of damages and as a viable separate cause of action altogether. *See* Fla. Dep't of Ins. v. Chase Bank of Tex. Nat'l Ass'n, 274 F.3d 924, 935-36 (5th Cir. 2001) (questioning whether Texas law recognizes tort of deepening insolvency as distinct cause of action); Alberts v. Tuft (*In re* Greater Se. Cmty. Hosp. Corp.), 333 B.R. 506, 517 (Bankr. D.D.C. 2005) (striking deepening insolvency as cause of action); Official Comm. of Unsecured Creditors of VarTec Telecom, Inc. v. Rural Tel. Fin. Coop. (*In re* VarTec Telecom, Inc.), 335 B.R. 631, 644 (Bankr. N.D. Tex. 2005) (refusing to recognize deepening insolvency as theory of damages or independent cause of action); Coroles v. Sabey, 79 P.3d 974, 983 (Utah Ct. App. 2003) (rejecting deepening insolvency as theory of damages).

8. *Cf. supra* note 7 (providing list of courts that have ruled on deepening insolvency claims and describing their various approaches to them).

9. *Compare* Seitz v. Detweiler, Hershey & Assoc., P.C. (*In re* CitX Corp.), 448 F.3d 672, 676 (3d Cir. 2006) (rejecting deepening insolvency as theory of damages and prohibiting deepening insolvency claims from being asserted solely on negligence), *with Lafferty*, 267 F.3d at 349 (holding that deepening insolvency was independent cause of action), *and infra* notes 28-41 and accompanying text (discussing court's holding in *Lafferty* and manner by which Third Circuit greatly expanded claims for deepening insolvency). For an analysis of how the court's holding in *CitX* reined in deepening insolvency, see *infra* notes 78-105 and accompanying text.

10. 267 F.3d 340 (3d Cir. 2001).

11. *See id.* at 347-50 (establishing deepening insolvency as separate and distinct cause of action). For a discussion of the court's holding in *Lafferty*, see *infra* notes 28-41 and accompanying text.

ruling in *Seitz v. Detweiler, Hershey and Associates (In re CitX Corp.)*[12] by severely limiting deepening insolvency's broad reach.[13] The *CitX* court held that allegations of negligence alone do not support a claim of deepening insolvency and that deepening insolvency may not be used as a theory of damages.[14] The court also expressly limited *Lafferty*'s precedential value to matters governed by Pennsylvania law.[15]

This Casebrief identifies the current status of deepening insolvency within Third Circuit jurisprudence and serves as a guide to practitioners bringing or defending against a claim of deepening insolvency.[16] Part II provides a review of the economic theories that led to the development of deepening insolvency and examines how various circuit courts have analyzed and interpreted challenges brought under this contemporary theory of liability.[17] Part III details the holding in *CitX* and the way in which the Third Circuit limited deepening insolvency claims.[18] Part IV reviews *CitX*'s widespread effect on deepening insolvency jurisprudence within the Third Circuit as well as the unmistakable and growing trend, within federal jurisprudence, toward significantly restricting claims for deepening insolvency.[19] Finally, Part V concludes that the constraints placed on deepening insolvency by the court in *CitX* will severely limit the number of deepening insolvency claims brought by trustees and creditors against corporations within the Third Circuit.[20]

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12. 448 F.3d 672 (3d Cir. 2006).

13. *See id.* at 677-78, 680 n.11, 681 (limiting claims for deepening insolvency). For a detailed analysis of the way in which *CitX* further restricted *Lafferty*, see *infra* notes 78-105 and accompanying text.

14. *See CitX*, 448 F.3d at 677-78, 681 (rejecting deepening insolvency as theory of damages and refusing to extend deepening insolvency to negligent acts). For a complete discussion of the court's holding in *CitX*, see *infra* notes 78-105 and accompanying text. For an analysis of the various ways lower courts interpreted the *Lafferty* holding, see *infra* notes 44-77 and accompanying text.

15. *See CitX*, 448 F.3d at 680 n.11 ("[N]othing we said in *Lafferty* compels any extension of the doctrine beyond Pennsylvania."). For a thorough analysis of *CitX*'s refusal to extend *Lafferty* beyond Pennsylvania, see *infra* notes 103-05 and accompanying text.

16. For a discussion of the status of deepening insolvency within the Third Circuit, see *infra* notes 78-105 and accompanying text.

17. For further discussion of the historical development of deepening insolvency within the Third Circuit and more generally within federal jurisprudence, see *infra* notes 42-77 and accompanying text.

18. For a discussion of the Third Circuit's holding in *CitX*, see *infra* notes 78-105 and accompanying text.

19. For a complete discussion of *CitX*'s wide-reaching impact on deepening insolvency jurisprudence within the Third Circuit and beyond, see *infra* notes 106-32 and accompanying text.

20. For support of this author's prediction that *CitX* will severely limit the number of deepening insolvency claims brought by trustees and creditors in the Third Circuit, see *infra* notes 111-32 and accompanying text.

II. DEEPENING INSOLVENCY'S CONTEMPORARY ROOTS

A. *Challenging Historical Notions of Liability from Insolvency*

Deepening insolvency is a developing theory of liability that evolved from cases concerning corporate officers who fraudulently extended the lives of corporations for personal financial gain.[21] In what is widely considered the first allusion to deepening insolvency in American jurisprudence, a New York district court concluded in *Bloor v. Dansker*[22] that "[a] corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it."[23] Three years later, the Seventh Circuit further challenged established notions of who could be deemed liable for a corporation's insolvency.[24] In *Schacht v. Brown*,[25] the court stated that at some point in a corporation's lifetime—in an effort to maximize asset value for stakeholders—it is more beneficial for a corporation to dissolve than to continue to operate, and that by deepening the company's insolvency, corporate management harms the corporation.[26] The Seventh Circuit's seemingly straightforward decision in *Schacht* brought the tort of deepening insolvency substantially closer to a viable and separate cause of action.[27]

B. *The Third Circuit Establishes Deepening Insolvency as an Independent Cause of Action*

The Third Circuit's controversial opinion in *Lafferty* crystallized the underlying theories that led to the development of deepening insolvency

21. *See* Bloor v. Dansker (*In re* Investors Funding Corp. Sec. Litig.), 523 F. Supp. 533, 539 (S.D.N.Y. 1980) (discussing fraudulent actions taken by corporate management that led to incurrence of additional debt); *see also* Bernstein & Malloy, *supra* note 6, at 415 ("The early cases that gave rise to the concept of deepening insolvency involved officers and directors who were alleged to have fraudulently prolonged the life of a corporation in order to benefit themselves, and who argued that there was no harm to the corporation . . . .").

22. 523 F. Supp. 533 (S.D.N.Y. 1980).

23. *Id.* at 541 (rejecting, in dicta, premise that it is always beneficial for corporate entity to remain solvent). The plaintiffs alleged in their complaint that three brothers manifested the false appearance of financial stability in an effort to conceal their past misconduct, and to raise additional capital to further their transgressions. *See id.* at 534 (stating factual background). This case represented the first time a court discussed what would later become the tort of deepening insolvency. *See* Howard Seife, *Bankruptcy for Bankers*, 122 BANKING L.J. 742, 743 (2005) ("The origin of the phrase 'deepening insolvency' has been traced to the case of *Bloor v. Dansker*.").

24. *See* Schacht v. Brown, 711 F.2d 1343, 1350 (7th Cir. 1983) (holding that corporate entities can be damaged through deepening insolvency).

25. 711 F.2d 1343 (7th Cir. 1983).

26. *See id.* at 1350 (rejecting earlier decisions that found extension of corporate existence is always beneficial and holding instead that "[t]his premise collides with common sense, for the corporate body is ineluctably damaged by the deepening of its insolvency, through increased exposure to creditor liability").

27. *See* Willett, *supra* note 4, at 550 (concluding that deepening insolvency evolved ever closer to independent action based on dictum in *Schacht*).

and elevated the tort of deepening insolvency beyond mere dicta.[28] In one fell swoop, the Third Circuit took the bold (and arguably misguided) step of establishing deepening insolvency as a distinct and viable cause of action under Pennsylvania law.[29] Resting its opinion on the reasoning outlined by the Seventh Circuit in *Schacht*, the Third Circuit held that Pennsylvania law recognized a cause of action for deepening insolvency as "an injury to [a debtor's] corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life."[30]

The seminal issue examined in *Lafferty* was whether an allegation of deepening insolvency was sufficient to give a debtor standing in federal court.[31] The Third Circuit held that deepening insolvency was a viable cause of action under Pennsylvania law and therefore the plaintiff had the requisite standing to assert the claim.[32] Although the Pennsylvania Supreme Court had not expressly recognized deepening insolvency as a distinct cause of action, the Third Circuit ruled that the theory of deepening insolvency was "essentially sound" because an insolvent corporation retains inherent value in its assets and corporate management seriously damages

28. *See* Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 347-50 (3d Cir. 2001) (establishing deepening insolvency as independent cause of action resulting from incurrence of additional corporate debt serving to prolong corporate entity).

29. *See id.* (holding deepening insolvency is separate and distinct cause of action that gives rise to actionable harm); *see also* Heaton, *supra* note 2, at 477-81 (noting significance of *Lafferty* in early development of deepening insolvency).

30. *See Lafferty*, 267 F.3d at 347 (defining deepening insolvency through Seventh Circuit's decision in *Schacht*). The *Lafferty* decision arose out of the bankruptcy of two leased financing corporations, which the Shapiro family owned and allegedly operated as a part of a "Ponzi scheme." *See id.* at 343 (stating factual background). A "Ponzi scheme" is defined as a "fraudulent investment scheme in which money contributed by later investors generates artificially high dividends for the original investors, whose example attracts ever larger investors." *See* BLACK'S LAW DICTIONARY 1198 (8th ed. 2004) (defining "Ponzi scheme"). In the present case, due to financial hardship, one of the companies was unable to raise capital sufficient to continue its business operations, and as such, the Shapiro family set up a "limited purpose financing subsidiary" solely to provide a means by which to sell debt securities under a different and untarnished business name. *See Lafferty*, 267 F.3d at 344-45 (stating factual background). Fraudulently marketing the second business as independent of the first allowed the family to incur large sums of additional debt. *See id.* (same). The family also misrepresented financial statements for both of the companies for the purpose of inducing investment companies to sell additional debt certificates. *See id.* (same). For a detailed synopsis of *Lafferty*'s factual background, see Richmond et al., *supra* note 4, at 136.

31. *See Lafferty*, 267 F.3d at 349 ("[W]e must now determine whether the alleged theory of injury—deepening insolvency—is cognizable under Pennsylvania law.").

32. *See id.* (affirming claim of deepening insolvency). The court held that "if faced with the issue, the Pennsylvania Supreme Court would determine that deepening insolvency may give rise to a cognizable injury." *See id.* (same). For a discussion of the court's rationale for establishing deepening insolvency as an independent actionable tort, see *infra* notes 33-41 and accompanying text.

the remaining value of the corporation by incurring additional debt.[33] The court identified four ways in which deepening insolvency harms the corporation.[34] The court noted that deepening insolvency harms the corporation by: (1) "inflicting legal and administrative costs" associated with bankruptcy on the corporation;[35] (2) creating "operational limitations" on the corporation that impede its ability to be profitable;[36] (3) undermining customer, supplier and employee relationships;[37] and (4) shaking the confidence of parties dealing with the corporation, causing the devaluation of corporate assets.[38] The court stated that "[t]hese harms can be averted, and the value within an insolvent corporation salvaged, if the corporation is dissolved in a timely manner, rather than kept afloat with spurious debt."[39] In its ruling, the court further noted that the growing acceptance of deepening insolvency in courtrooms across the country, as well as the importance under Pennsylvania law of providing a remedy when there is an injury, effectively cemented deepening insolvency as a valid cause of action under Pennsylvania law.[40] Under these precepts, the Third Circuit

33. *See Lafferty*, 267 F.3d at 349 (holding that although "[n]either the Pennsylvania Supreme Court nor any intermediate Pennsylvania court has directly addressed this issue," corporation was harmed by deepening insolvency). Whether a jurisdiction recognizes claims for deepening insolvency is an issue whose ultimate conclusion rests with state supreme courts. *See id.* at 349 (stating that insofar as Pennsylvania Supreme Court had not addressed issue, "we must don the soothsayer's garb and predict how that court would rule if it were presented with the question").

34. For a discussion of the manner by which deepening insolvency harms corporations, see *infra* notes 35-39 and accompanying text.

35. *See Lafferty*, 267 F.3d at 349-50 (citing RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 487 (5th ed. 1996)) (noting heightened legal and administrative costs associated with deepening firm's insolvency).

36. *See id.* (citing BREALEY & MYERS, *supra* note 35, at 488-89) (discussing how deepening insolvency can hinder corporation's ability to remain profitable).

37. *See id.* (illustrating negative effects that deepening insolvency may have on outside parties).

38. *See id.* (describing harm to corporation's assets that can result from deepening insolvency).

39. *See id.* at 350 (noting methods by which corporations can limit their insolvency). To support the underpinnings of this controversial theory, the court stated that the "acceptance of a rule which would bar a corporation from recovering damages due to the hiding of information concerning its insolvency would create perverse incentives for wrong-doing officers and directors to conceal the true financial condition of the corporation from the corporate body as long as possible." *See id.* (ruling that corporations are harmed by deepening insolvency). *But see* Willett, *supra* note 4, at 565 (rejecting proposition that debtor is harmed by increasing insolvency).

40. *See Lafferty*, 267 F.2d at 352 ("In sum, we believe that the soundness of the theory, its growing acceptance among courts, and the remedial theme in Pennsylvania law would persuade the Pennsylvania Supreme Court to recognize deepening insolvency as giving rise to a cognizable injury in the proper circumstances."); *accord* Paul Rubin, *New Liability Under Deepening Insolvency—The Search for Deep Pockets*, 23-Apr AM. BANKR. INST. J. 50, 68 (2004) (noting *Lafferty*'s explicit acknowledgment of deepening insolvency as separate cause of action). Nevertheless, the court went on to hold that the plaintiff was barred from bringing a claim on the debtors'

laid the foundation for deepening insolvency as an independent cause of action.[41]

C. *The Unintended Consequences of Deepening Insolvency's Widening Reach*

The *Lafferty* decision immediately sent shockwaves through the business community, which was unsure of the depths deepening insolvency might reach and was weary of the growing acceptance of this newfound legal theory.[42] The decision also caused significant consternation within federal courts, spawning two distinct lines of cases that expanded the scope of deepening insolvency and interpreted the *Lafferty* holding in dramatically different fashions.[43] One progeny of cases extended *Lafferty*'s reasoning to hold that deepening insolvency could be utilized as a theory of damages to measure the harm caused by breaching a fiduciary duty or a duty of care.[44] Another line of cases rejected deepening insolvency as a

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behalf by the doctrine of *in pari delicto*. *See Lafferty*, 267 F.3d at 349 (rejecting plaintiff's argument). The doctrine *in pari delicto* is "the equitable doctrine that a court should not assist a participant in a wrongful act to profit from it. Traditionally . . . [t]he knowledge and conduct of corporate officials acting within the scope of their duties generally is imputed to the corporation." *See* Willett, *supra* note 4, at 557-58 (defining *in pari delicto*). In the instant case, plaintiff's claim was barred because the officers' and directors' misconduct would be imputed to the debtor. *See Lafferty*, 267 F.3d at 350 (rejecting plaintiff's argument). *But see* Willett, *supra* note 4, at 560 ("There is little doubt that the doctrine of *in pari delicto* is now in retreat.").

41. *See* David Gordon, *The Expansion of Deepening Insolvency Standing: Beyond Trustees and Creditors' Committees*, 22 EMORY BANKR. DEV. J. 221, 224-25 (2005) (concluding that *Lafferty* laid foundation for modern deepening insolvency jurisprudence); Harrell, *supra* note 4, at 154-57 (noting that *Lafferty* was "benchmark" case recognizing deepening insolvency).

42. *See, e.g.*, Maaren A. Choksi, *Sink or Swim? A Case for Salvaging Deepening Insolvency Theory*, 7 J. BUS. & SEC. L. 163, 170 (2007) (noting that "at a time when the threat of large corporate bankruptcies (e.g., Enron) and resulting investor harm was just crashing into the public consciousness[,]" the "infamous" *Lafferty* decision "exploded into the mainstream . . . ."); Russell C. Silberglied, LTV *and Post-Petition Deepening Insolvency: The Next Big Wave?*, 25-Feb AM. BANKR. INST. J. 1, 1 (2006) ("Few theories in recent years have generated more ink—whether in the form of pleadings, court decisions or academic debate—than 'deepening insolvency.'").

43. For a discussion of *Lafferty*'s progeny, see *infra* notes 44-77 and accompanying text.

44. *See, e.g.*, Fla. Dep't of Ins. v. Chase Bank of Tex. Nat'l Ass'n, 274 F.3d 924, 935 (5th Cir. 2001) (holding deepening insolvency may be used as theory of damages); Bookland of Me. v. Baker, Newman & Noyes, 271 F. Supp. 2d 324, 325 (D. Me. 2003) (utilizing deepening insolvency as theory of damages); Tabas v. Greenleaf Ventures, Inc. (*In re* Flagship Healthcare Inc.), 269 B.R. 721, 727-28 (Bankr. S.D. Fla. 2001) (broadening deepening insolvency to include its use as measure of damages). *But see* Seitz v. Detweiler, Hershey & Assoc., P.C. (*In re* CitX Corp.), 448 F.3d 672, 677-78 (3d Cir. 2006) (ruling that prior holding in *Lafferty* "should not be interpreted to create a novel theory of damages for an independent cause of action like malpractice"); Heaton, *supra* note 2, at 480 ("Few courts seem to realize that *Lafferty* did not endorse the idea that wrongfully-incurred unpayable debt, per se, measures injury to a corporation."). For a complete discussion of *CitX*'s rejec-

measure of damages, but widened the spectrum of those conceivably liable for deepening insolvency—concluding that stakeholders could hold *both* corporate management and lenders liable.[45] What had begun as a rejection of the oft-cited proposition, that any act which extends the life of a corporation must inherently be beneficial to it, was transformed into a powerful tool by which creditors could recoup financial losses resulting from insolvency.[46]

1. *Deepening Insolvency as a Theory of Damages*

The *Lafferty* decision sought to curb the fraudulent behavior of corporate insiders who *intentionally* extended the life of an insolvent corporation for personal financial gain.[47] The first court to build on the analysis set forth in *Lafferty*, however, considered the more controversial issues of whether to extend deepening insolvency to *negligent* acts and whether to apply it as a theory of damages.[48] In *Tabas v. Greenleaf Ventures, Inc. (In re Flagship Healthcare, Inc.)*,[49] a Florida bankruptcy court held that the negligent valuation of goodwill acquired by Flagship Healthcare, which contributed in large part to its subsequent insolvency, was sufficient to establish a claim for deepening insolvency as a theory of damages.[50] Relying on a negligently prepared financial analysis, Flagship Healthcare incurred exor-

tion of deepening insolvency as a measure of damages, see *infra* notes 91-97 and accompanying text.

45. *See, e.g.*, OHC Liquidation Trust v. Credit Suisse First Boston (*In re* Oakwood Homes Corp.), 340 B.R. 540, 531 (Bankr. D. Del. 2006) (relying on *Lafferty* to rule that deepening insolvency would be recognized under Delaware, New York and North Carolina law as independent cause of action); Stanziale v. Pepper Hamilton LLP (*In re* Student Fin. Corp.), 335 B.R. 539, 548 (D. Del. 2005) (following *Lafferty* and holding that deepening insolvency is independent cause of action); *In re* LTV Steel Co., 333 B.R. 397, 422 (Bankr. N.D. Ohio 2005) (upholding deepening insolvency as independent cause of action); Miller v. Dutil (*In re* Total Containment, Inc.), 335 B.R. 589, 619 (Bankr. E.D. Pa. 2005) (same); Official Comm. of Unsecured Creditors v. Credit Suisse First Boston (*In re* Exide Techs., Inc.), 299 B.R. 732, 733 (Bankr. D. Del. 2003) (holding that Delaware law recognized deepening insolvency as valid cause of action). For a thorough discussion of the court's holding in *Exide*, see *infra* notes 60-64 and accompanying text.

46. *See, e.g.*, Paul Rubin, *Deepening Insolvency is Sinking Fast*, THE BANKRUPTCY STRATEGIST, 24 No. 2A, (Dec. 2006-Jan. 2007) ("Five years ago, the Third Circuit Court of Appeals opened the door to extensive litigation by holding, in [*Lafferty*] that Pennsylvania law would recognize a cause of action for deepening insolvency.").

47. For a complete discussion of the factual background and holding in *Lafferty*, see *supra* notes 28-41 and accompanying text.

48. *See Flagship Healthcare*, 269 B.R. at 726; Harrell, *supra* note 4, at 161-64 (stating that "[*Flagship Healthcare*] involves the expansion of insolvency based on the negligent act of a third-party professional."). For an analysis of the issues before the court in *Flagship Healthcare*, see *infra* notes 49-52 and accompanying text.

49. 269 B.R. 721 (Bankr. S.D. Fla. 2001).

50. *See id.* at 727-28 (affirming *Lafferty*'s analysis that theory of deepening insolvency could be utilized as theory of damages). The court succinctly described the situation in lay terms stating that:

bitant amounts of additional debt to finance the acquisition of another company and the execution of certain loan transactions.[51] The court stated that, although not specifically pled as such, the additional debt incurred as a result of the defendant's negligence "may provide a measure of damages recoverable by the Trustee."[52]

The *Flagship Healthcare* ruling is significant in the development of deepening insolvency jurisprudence for two reasons.[53] First, it began the imprudent expansion of deepening insolvency to include negligent acts committed by third parties.[54] The incorporation of negligence into the doctrine worried many observers that subsequent courts might extend the lowered standard to decisions effectuated by corporate management.[55]

> [T]he Debtor's situation was not like an individual who sits in the rain all day and simply cannot get more wet. It is more akin to a boxer with one black eye who, despite being injured, might still persevere and win the fight. If that boxer (the debtor) winds up losing the fight and landing in the hospital (bankruptcy court), a doctor (judge) might find that it was the additional injuries (deepening insolvency) which put him there.

Id. at 724 n.4 (finding facts sufficient to establish claim for deepening insolvency).

51. *See id.* at 725 (detailing terms of acquisition, term loan agreement and revolving credit facility executed in reliance on financial analysis). The plaintiff alleged that the financial advisor owed a duty of due professional care to the creditor and that it had breached this duty. *See id.* (claiming negligence in preparation of financial analysis that endorsed goodwill valuation). The plaintiff further alleged "that 'the Greenleaf valuation was materially unreliable and incorrect' and 'materially overstated the value of Flagship's goodwill.'" *See id.* (noting several specific errors or omissions in valuation process). The court held that the negligent acts were sufficient to satisfy the requirements of deepening insolvency established in *Lafferty*. *See id.* at 728 ("The financial hardships which possibly resulted from the increased insolvency were not necessarily forthcoming, and if it can be proven that they were a result of the increased insolvency, liability may be found.").

52. *Id.* (utilizing deepening insolvency as measure of damages as opposed to cause of action). *But see infra* notes 92-97 (discussing inherent flaws in holding that deepening insolvency is applied correctly as theory of damages).

53. For a discussion of *Flagship Healthcare*'s important role in the development of deepening insolvency jurisprudence, see *infra* notes 54-59 and accompanying text.

54. *See* Harrell, *supra* note 4, at 164 (discussing facts of *Flagship Healthcare* by noting that case involves deepening insolvency claim based on negligent act of third-party professional). The Ninth Circuit has improvidently drawn on the reasoning set forth in *Flagship Healthcare* and has extended deepening insolvency to negligent acts. *See* Smith v. Arthur Andersen LLP, 421 F.3d 989, 995 (9th Cir. 2005) (recognizing deepening insolvency for unintentionally misrepresenting firm's insolvency). For a detailed analysis of *Flagship Healthcare*'s misguided extension of deepening insolvency to include negligent acts, see *supra* notes 48-52 and accompanying text.

55. *See* Harrell, *supra* note 4, at 167-68 (sounding concern that "the deepening insolvency theory could extend to negligently informed decisions of officers and directors, thereby negating the business judgment presumption in the realm of potential insolvency"). One commentator has noted that allowing trustees to assert deepening insolvency claims based solely on negligence may:

> provide a cause of action in tort against officers and directors, supplanting a breach of fiduciary duty claim . . . . [A] cause of action in tort against officers and directors that circumvents the business judgment rule

This distinction is crucial because it would allow shareholders to circumvent the business judgment rule and the penumbra of protection the rule affords corporate executives who act in good faith in accordance with their fiduciary duties.[56]

Second, *Flagship Healthcare* was one of the first decisions to treat deepening insolvency as a measure of damages resulting from wrongfully incurred debt rather than as an independent cause of action.[57] The use of deepening insolvency as a theory of damages is problematic because it does not reflect an accurate measure of harm to the corporation resulting from the defendant's acts and is "inconsistent with the traditional understanding . . . of corporate injury."[58] These two issues, highlighted in the

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> may potentially create a decline in the market for corporate directors, which in turn would have a damaging impact on corporate governance and possibly the economy as a whole.

Id. (explaining risk that deepening insolvency tort poses to corporate governance).

56. *See* Harrell, *supra* note 4, at 151-54 (discussing protection from liability that business judgment rule affords corporation's executives and directors). The business judgment rule allows corporate executives to make tactical business decisions in the best interest of their company without fear that they will be liable if their decisions fail to maximize value, or if in the worst instance, they result in insolvency. *See id.* at 151-54 (discussing protection from liability that business judgment rule affords corporations' executives). Specifically, the business judgment rule provides:

> [I]n making business decisions not involving direct self-interest or self dealing, corporate directors act on an informed basis, in good faith, and in the honest belief that their actions are in the corporation's best interest. The rule shields directors and officers from liability for unprofitable or harmful corporate transactions if the transaction were made in good faith, with due care, and within the directors' or officers authority.

BLACK'S LAW DICTIONARY 212 (8th ed. 2004).

57. *See* Heaton, *supra* note 2, at 480-81 (arguing *Flagship Healthcare* mistakenly interpreted *Lafferty*'s holding). One commentator has stated that "[w]ithout saying so directly, the *Lafferty* court produced an opinion that has been read incorrectly to endorse wrongfully-incurred unpayable debt as a measure of injury to a corporation." *See id.* (discussing varying misinterpretations of *Lafferty* ruling).

58. *See* Bernstein & Malloy, *supra* note 6, at 415 n.43 (detailing shortcomings of deepening insolvency as theory of damages). One commentator has further noted the inconsistencies within the theory, stating that:

> One may legitimately question whether deepening insolvency is a proper measure of damages in these cases. Why not instead measure the damages . . . by actually quantifying the harm suffered as a result of actions taken by the defendant? Moreover, why should the damage calculation differ between (1) a company that is insolvent and then rendered more insolvent by wrongful conduct, and (2) a company that begins solvent but is rendered insolvent by the same conduct? Yet, deepening insolvency seems to imply a different measure of damages in the case when the company begins insolvent and then is rendered more insolvent. Because of these and similar questions, there will continue to be doubt about the validity of deepening insolvency as a measure of damages.

Id. (noting flaws in asserting deepening insolvency as theory of damages); *see also* Heaton, *supra* note 2, at 500 (concluding that use of deepening insolvency as theory of damages is unsupported in financial economic theory).

Flagship Healthcare decision, have plagued the muddled cloud of deepening insolvency jurisprudence since its inception.[59]

2. *Deepening Insolvency as an Independent Cause of Action*

A different progeny of cases, following directly in *Lafferty*'s footsteps, further expanded deepening insolvency as a distinct and separate action to include lenders as defendants.[60] In *Official Committee of Unsecured Creditors Suisse First Boston (In re Exide Technologies, Inc.)*,[61] a bankruptcy court for the District of Delaware held that when lenders issued additional debt as a means of granting themselves security interests in the debtor's corporation, they caused the corporation to operate at "ever increasing levels of insolvency," thus giving the creditors standing to assert a claim of deepening insolvency against the lenders.[62] The bankruptcy court acknowledged

59. *See* Willett, *supra* note 4, at 561-64 (discussing number of opinions within deepening insolvency jurisprudence over last twenty-five years that have struggled to determine whether deepening insolvency is independent cause of action or measure of damages). Certain courts have upheld deepening insolvency as a measure of damages. *See* Allard v. Arthur Andersen & Co., 924 F. Supp. 488, 494 (S.D.N.Y. 1996) (indicating deepening insolvency is theory of damages); Hannover Corp. of Am. v. Beckner, 211 B.R. 849, 854 (Bankr. M.D. La. 1997) (recognizing deepening insolvency as method of calculating corporation's damages that includes amount of indebtedness incurred from prolonging life of insolvent business). Other courts have repudiated deepening insolvency as a theory of damages. *See* Official Comm. of Unsecured Creditors of VarTec Telecom, Inc. v. Rural Tel. Fin. Coop. (*In re* VarTec Telecom, Inc.), 335 B.R. 631, 644 (Bankr. N.D. Tex. 2005) (refusing to recognize deepening insolvency as theory of damages or independent cause of action); Coroles v. Sabey, 79 P.3d 974, 983 (Utah Ct. App. 2003) (rejecting deepening insolvency as theory of damages).

60. *See* Official Comm. of Unsecured Creditors v. Credit Suisse First Boston (*In re* Exide Techs., Inc.), 299 B.R. 732, 752 (Bankr. D. Del. 2003) (finding actionable claim for deepening insolvency against defendant lenders); *see also* Willett, *supra* note 4, at 549 (noting that "a Delaware court moved the theory to its next step, ruling that a plaintiff stated a claim against a lender on the theory that the lender's prepetition loan helped deepen the insolvency of a Chapter Eleven debtor").

61. 299 B.R. 732 (Bankr. D. Del. 2003).

62. *See id.* at 752 (upholding deepening insolvency as independent cause of action). In 1997, Exide borrowed large sums of money from Credit Suisse First Boston. *See id.* at 736 (stating bank provided $650 million credit facility and loaned another $250 million for acquisition). Three years later Exide borrowed additional money to finance the acquisition of GNP Dunlop; however, in exchange for this extension of credit, Exide granted First Boston additional collateral and guarantees. *See id.* (same). The effect of the transaction "was to increase significantly the Pre-Petition Banks' control over the Exide Group." *See id.* (stating facts that led to quasi-transfer of control). The plaintiff-creditors alleged that First Boston effectively forced Exide to purchase GNP Dunlop so that First Boston would be able to obtain control over the entity and thereby force Exide to operate at increasing levels of insolvency. *See id.* at 751 (stating plaintiff's argument for claim of deepening insolvency). The syndicate argued that insofar as the Delaware Supreme Court had not recognized a claim for deepening insolvency, the bankruptcy court should dismiss the action for failure to state a claim. *See id.* (asserting that "deepening insolvency action is not recognized under Delaware law"). The bankruptcy court disagreed and recognized the tort of deepening insolvency under Del-

that neither the Delaware Supreme Court nor other intermediate courts had addressed whether litigants could assert a tort claim for deepening insolvency under that state's laws.[63] Nevertheless, the court utilized the analysis set forth in *Lafferty* and held that Delaware law would recognize a claim for deepening insolvency if there has been "damage to corporate property."[64]

Many practitioners and commentators characterized the *Exide* rule as a judicial escalation of the tort of deepening insolvency because it enabled creditors to sue lenders, as opposed to corporate management, for the issuance of additional debt.[65] This variation and expansion of the *Lafferty* holding caught the ire of many corporate insiders due to the large concentration of companies incorporated in Delaware and because of the constraints that the decision placed on lenders extending insolvent corporations additional credit.[66]

D. *The Push Back: Judicial Backlash Against Deepening Insolvency*

The speed with which deepening insolvency had rapidly evolved into both an independent cause of action and a theory of damages brought the bankruptcy tort to the forefront of legal discourse.[67] The legal and economic theories that form its basis, however, began to face increasing skep-

aware law. *See id.* at 752 ("The tort of deepening insolvency has been pled sufficiently by the Plaintiffs."); *see also* Rubin, *supra* note 40, at 50 (explaining facts of *Exide*). Delaware state courts have subsequently diverged from *Exide*'s conclusions, holding that Delaware law does not recognize the tort of deepening insolvency. *See* Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 207 (Del. Ch. 2006) (rejecting premise that Delaware recognizes deepening insolvency claims).

63. *See Exide*, 299 B.R. at 751 ("The Supreme Court of Delaware has not spoken on the tort of deepening insolvency. For this reason, I must predict how the Delaware Supreme Court would rule on the claim if such claim was presented to it.").

64. *See id.* at 751-52 (finding for plaintiffs). The court held that "based on the Third Circuit's decision in *Lafferty* and the Delaware courts' policy of providing a remedy for an injury . . . [the] Delaware Supreme Court would recognize a claim for deepening insolvency when there has been damage to corporate property." *Id.* at 752. The court reasoned that all of the elements of the *Lafferty* test had been met and, therefore, it was likely that the Delaware Supreme Court would, if given the opportunity, affirm the tort of deepening insolvency as a separate and distinct cause of action. *See id.* (ruling that deepening insolvency was actionable under Delaware law).

65. For a discussion on the court's expansion of deepening insolvency to include lenders as defendants in deepening insolvency causes of action, see *supra* notes 61-64 and accompanying text.

66. *See, e.g.*, Jonathan M. Landers, *Deepening Insolvency Comes of Age*, N.Y.L.J., Oct. 5. 2006, at 4 ("Many U.S. corporations are venued in Delaware, and a significant number of cases raising questions of deepening insolvency have involved Delaware corporations.")

67. *See, e.g.*, James M. Peck, David M. Jillman & Elizabeth L. Rose, *"Deepening Insolvency": Litigation Risks for Lenders and Directors When Out-Of-Court Restructuring Efforts Fail*, 1 N.Y.U. J.L. & BUS. 293, 293 (2004) (concluding that deepening insolvency is "unfortunate and troubling for lenders, directors, and advisors involved in

ticism by courts across the country.[68] In *Kittay v. Atlantic Bank of New York (In re Global Service Group, LLC)*,[69] a bankruptcy court for the Southern District of New York refused to recognize deepening insolvency as either an independent cause of action or a theory of damages.[70] The court rejected a trustee's argument that a lender knew or should have known Global Service Group was insolvent, and that by lending it additional sums of money in light of this knowledge, the lender induced other creditors to follow suit.[71] The trustee asserted that the extension of this credit to Global served to "prolong its corporate existence" and increased the corporation's debt.[72] The court held, however, that absent allegations the lender acted in bad faith or in a fraudulent manner, lending an insolvent corporation may be "bad banking," but it is *not* an actionable tort.[73]

The *Global Service Group* decision curbed the expansion of deepening insolvency claims by asserting that the prolongation of a corporate entity through the incurrence of additional debt will not, by itself, give rise to actionable harm.[74] The court held that, in order to state a claim, the plaintiff "must show that the defendant prolonged the company's life in breach of a separate duty, or committed an actionable tort that contributed to the continued operation of a corporation and its increased debt."[75] The court also upheld the applicability of the business judgment

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pre-bankruptcy restructurings"); Richmond et al., *supra* note 4, at 131 (illustrating that deepening insolvency is increasingly popular cause of action).

68. *See, e.g.*, Bondi v. Citigroup, Inc., No. BER-L-10902-04, 2005 WL 975856, at *21 (N.J. Super. Ct. Law Div. Feb. 28, 2005) (rejecting deepening insolvency as independent cause of action); Coroles v. Sabey, 79 P.3d 974, 983 (Utah Ct. App. 2003) ("Although deepening insolvency might harm a corporation's shareholders, it does not, without more, harm the corporation itself."); William Bates III, *Deepening Insolvency: Into the Void*, 24-Mar AM. BANKR. INST. J. 1, 1, 60-62 (discussing limitations and flaws in deepening insolvency); Heaton, *supra* note 2, at 500 (arguing that deepening insolvency is "unsupported in financial economics and inconsistent with the traditional understanding and economic functions of corporate injury"); Willett, *supra* note 4, at 574-75 (disputing notion that deepening insolvency can cause harm to corporate entity).

69. 316 B.R. 451 (Bankr. S.D.N.Y. 2004).

70. *See id.* at 458 (rejecting deepening insolvency as both independent tort and theory of damages). One commentator has noted that the *Global Service Group* decision "injected much-needed sense into the discussion by ruling that 'deepening insolvency' is not a cause of action at all." *See* Willett, *supra* note 4, at 551 (discussing impact of *Global Service Group*'s rejection of deepening insolvency).

71. *See Global Serv. Group*, 316 B.R. at 459 (rejecting argument that lender induced other creditors to loan money to Global Service Group).

72. *See id.* at 455-56 (alleging lender deepened Global Service Group's insolvency).

73. *See id.* at 459 ("A third party is not prohibited from extending credit to an insolvent entity; if it was, most companies in financial distress would be forced to liquidate.").

74. *See id.* (rejecting deepening insolvency claims without breach of separate duty).

75. *Id.* at 458 (holding that deepening insolvency claims require breach of independent duty to corporation that results in deepening corporation's insolvency); *see also* John Weitnauer, *Will "Deepening Insolvency" Succeed as a New Theory*

rule within the zone of insolvency, concluding that a director's negligent decision to continue to operate an insolvent business would not subject the director to liability.[76] *Global Service Group*'s direct repudiation of *Lafferty* and its progeny began a growing trend to limit the widening reach of deepening insolvency.[77]

III. THE THIRD CIRCUIT REINS IN DEEPENING INSOLVENCY IN *CITX*

A. *Taking Aim at* Lafferty

In the five short years following the *Lafferty* decision, the tort of deepening insolvency became a judicial juggernaut spreading its tentacles of liability into the deep pockets of everyone conceivably liable for deepening a corporation's insolvency.[78] Unhinged from rational judicial constraints, stakeholders utilized the tort to sue a corporation's auditors, lawyers, underwriters and even lenders who provided additional credit to distressed entities.[79] Largely as a reaction to the various misinterpretations of *Lafferty*, the Third Circuit in *CitX* took aim at deepening insolvency and successfully limited its reach in three ways: (1) the court held that deepening insolvency may not be invoked as a theory of damages to support a malpractice cause of action;[80] (2) the court ruled that a deepening insolvency claim cannot be sustained solely on an allegation of negligent conduct;[81] and (3) the court ruled that *Lafferty*'s precedential value was limited to courts within Pennsylvania.[82]

Under Lender Liability?, 59 CONSUMER FIN. L.Q. REP. 430, 430-32 (2005) (detailing *Global Service Group*'s rejection of deepening insolvency as independent cause of action and theory of damages).

76. *See Global Serv. Group*, 316 B.R. at 461 ("To overcome the business judgment rule, a complaint must contain specific allegations that the fiduciary acted in bad faith or with fraudulent intent."). For a complete discussion of the protection the business judgment rule affords corporate management, see *supra* note 56, and *infra* notes 118-23 and accompanying text.

77. For a discussion of cases that began to limit deepening insolvency, see *infra* notes 124-32 and accompanying text.

78. For a discussion of the manner by which deepening insolvency was expanded by two distinct lines of cases, see *supra* notes 42-66 and accompanying text.

79. For a complete discussion of the manner by which deepening insolvency expanded to various defendants, see *supra* notes 60-66 and accompanying text.

80. *See* Seitz v. Detweiler, Hershey & Assoc., P.C. (*In re* CitX Corp.), 448 F.3d 672, 677-78, 680 n.11, 681 (3d Cir. 2006) (rejecting deepening insolvency as theory of damages for malpractice suits); *see also* Jo Ann Brighton, *Deepening the Blows Against Insolvency? The Third Circuit's* CitX *Opinion and Post-*CitX *Opinions*, 25-Sep AM. BANKR. INST. J. 24, 24-25 (2006) ("*CitX* has dealt quite a blow to deepening insolvency."). For a complete discussion the court's decision to reject deepening insolvency as a theory of damages, see *infra* notes 91-97 and accompanying text.

81. *See CitX*, 448 F.3d at 681 ("[W]e hold that a claim of negligence cannot sustain a deepening-insolvency cause of action."). For further discussion on the court's holding regarding negligence, see *infra* notes 98-102 and accompanying text.

82. *See CitX*, 448 F.3d at 680 n.11 ("[N]othing we said in *Lafferty* compels any extension of the doctrine beyond Pennsylvania."). For further discussion on the

B. *Factual Background*

CitX Corporation, a former Internet company, utilized its prepared financial statements to attract inventors as part of an illegal "Ponzi scheme."[83] The Florida Attorney General terminated the operations of CitX's most profitable customer, Professional Resources Systems International (PRSI), because it was operating as a "fraudulent enterprise."[84] PRSI was CitX's only significant client, and at the time PRSI ceased operating, it owed CitX $2.4 million.[85] CitX continued to show the account receivable as an asset, which allowed CitX to appear solvent.[86] In reality, had CitX reflected the loss of the receivable, its liabilities would have exceeded its assets.[87] By continuing to show the receivable, CitX was able to sell additional equity securities for more than $1 million.[88] Soon thereafter, CitX filed for Chapter 11 bankruptcy, and the trustee in bankruptcy sued the corporation's accounting firm, Detweiler, Hershey & Associates, alleging that the negligently prepared financial information enabled CitX to secure $1 million in additional equity, which allowed CitX to continue operating and incurring debt.[89] The trustee stated that this additional equity "dramatically deepened the insolvency of CitX, and wrongfully expanded the debt of CitX and waste of its illegally raised capital."[90]

C. *Third Circuit Rejects Deepening Insolvency as a Theory of Damages*

A three judge panel (including one of the judges who issued the *Lafferty* ruling) held in *CitX* that deepening insolvency may not be invoked as

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court's refusal to extend *Lafferty* beyond Pennsylvania, see *infra* notes 103-05 and accompanying text.

83. *See CitX*, 448 F.3d at 674-675 (stating factual background). For a definition of a "Ponzi scheme," see *supra* note 30.

84. *See id.* (stating factual background). CitX joined with PRSI to create an internet shopping mall for home-based merchants that paid a fee to be featured online. *See id.* (same). PRSI illegally scammed close to $18,000,000 from its clients, and CitX received approximately $700,000 of this money. *See id.* (same).

85. *See id.* at 674 (noting CitX's large sum of indebtedness).

86. *See id.* ("In CitX's compiled financials, this was all that was keeping the company theoretically in the black.").

87. *See id.* (describing CitX's financial background).

88. *See id.* (noting method by which CitX increased its insolvency).

89. *See id.* at 675-76 (describing factual background). The complaint contained four separate causes of action: malpractice, deepening insolvency, breach of fiduciary duty and negligent misrepresentation. *See id.* (detailing complaint).

90. *See id.* at 677-78 (arguing that infusion of equity allowed CitX to continue operating while management incurred "millions more in debt"). Additionally, the trustee argued that the accounting firm overlooked several warning signs that should have alerted it to CitX's impending financial problems. *See id.* at 675 (noting plaintiff's allegations). For example, CitX's own bookkeeper had not completed high school, and the only asset purportedly keeping CitX solvent was an account receivable from a corporation that the Attorney General had shut down because of fraud. *See id.* at 675 (noting plaintiff's allegations).

a theory of damages to support an independent cause of action.[91] In the immediate malpractice suit, the trustee sought to establish the harm done to CitX by asserting deepening insolvency as a theory of damages.[92] The court utilized its ruling in *CitX* to further illuminate *Lafferty* and noted that, although it had described deepening insolvency as a "theory of injury," it had not held that deepening insolvency was a valid theory of damages for an independent cause of action.[93] The court ruled that prior statements in *Lafferty* "were in the context of a deepening-insolvency cause of action" and "should not be interpreted to create a novel theory of damages for an independent cause of action . . . ."[94]

Additionally, the court in *CitX* held that summary judgment was appropriate because the trustee did not establish the requisite harm to the corporation.[95] Even assuming that Detweiler's negligently prepared financial statements enabled CitX to procure an additional $1 million in capital investments, the court ruled that the action did not "deepen CitX's insolvency, but rather, it did the opposite."[96] Using legal reasoning that seemingly turned deepening insolvency on its head, the court declared that any increase in insolvency resulting from the debt incurred after equity was raised was the result of CitX's management, not the accountants, and therefore Detweiler could not be held liable for deepening the corporation's insolvency.[97]

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91. *See id.* at 677 (rejecting deepening insolvency as theory of damages); *see also* Brighton, *supra* note 80, at 24 (noting that same judge presided over *CitX* and *Lafferty* opinions).

92. *See CitX*, 448 F.3d at 677 (stating that plaintiff's complaint "allege[d] harm to it in the form of 'deepening insolvency'").

93. *See id.* (clarifying *Lafferty* holding and limiting its scope). The court recognized that its prior holding in *Lafferty* was responsible for some of the confusion regarding whether deepening insolvency is a "type of injury," a "theory of injury" and/or an "independent cause of action." *See id.* (discussing ambiguous language of *Lafferty*).

94. *See id.* at 677 (rejecting deepening insolvency as theory of damages for malpractice suit). Although the holding rejects deepening insolvency as a theory of damages solely for claims based on negligence, the court stated in dicta that its decision was not meant to imply that deepening insolvency was a theory of damages for other claims either. *See id.* at 677 n.8 ("By this we do not mean to imply that deepening insolvency would be a valid theory of damages for any other cause of action, such as fraud, and *Lafferty* did not so hold.").

95. *See id.* at 677 ("Seitz did not provide sufficient evidence to allow a reasonable jury to find harm.").

96. *See id.* at 677 (holding that CitX's insolvency "decreased rather than deepened" because equity investment increased company assets with no corresponding increase in liabilities).

97. *See id.* at 678 (rejecting plaintiff's argument). Discussing the underlying theories behind deepening insolvency, the court stated "[t]he deepening of a firm's insolvency is not an independent form of corporate damage. Where an independent cause of action gives a firm a remedy for . . . the decrease in fair asset value[,] . . . then the firm may recover, without reference to the impact upon the solvency calculation." *See id.* (citing Willett, *supra* note 4, at 575) (questioning whether deepening insolvency is harmful to corporate entities).

D. *Third Circuit Rejects Negligence as a Basis for Deepening Insolvency Claims*

The Third Circuit proceeded in *CitX* to further circumscribe the unintended impact of *Lafferty* by holding that allegations based solely on negligence are insufficient to support a claim of deepening insolvency.[98] The trustee's allegations centered on the claim that Detweiler missed several obvious discrepancies that should have alerted the firm to the errors in the financial statements.[99] As a result of Detweiler's negligently prepared financial statements, the trustee asserted that CitX was able to obtain $1 million in capital investments thus deepening CitX's insolvency.[100] The court rejected this argument, stating that "a claim of negligence cannot sustain a deepening-insolvency cause of action."[101] The court refused to expand *Lafferty* beyond its exact wording, holding that claims for deepening insolvency may only arise from the "fraudulent expansion of corporate debt and prolongation of corporate life."[102]

E. *Limiting* Lafferty*'s Precedential Value*

The *CitX* decision further curtailed the expansion of deepening insolvency by explicitly limiting *Lafferty*'s value as precedent to matters governed by Pennsylvania law.[103] The court cautioned that "[a]lthough some courts in this Circuit have extended *Lafferty*'s reasoning to other states . . . nothing we said in *Lafferty* compels any extension of the doctrine beyond Pennsylvania."[104] The Third Circuit went so far as to admonish other courts within the circuit for extending deepening insolvency beyond its proscribed limitations and relying on *Lafferty* to find an independent cause of action for deepening insolvency under Delaware and New York law.[105]

IV. *CitX*'s Effect on Deepening Insolvency Jurisprudence and Corporate Governance

The *CitX* decision is consistent with the expanding body of law that has begun to limit the much-maligned *Lafferty* decision and systematically

98. *See id.* at 680 (rejecting negligence as basis for deepening insolvency claims).

99. *See id.* (discussing trustees allegations).

100. *See id.* ("Without fraud, Seitz must fall back on his allegation that Detweiler negligently deepened CitX's insolvency, [and] we must decide whether an allegation of negligence can support a claim of deepening insolvency.").

101. *See id.* at 681-82 (holding negligence insufficient to establish claim for deepening insolvency).

102. *See id.* at 680-81 ("We know no reason to extend the scope of deepening insolvency beyond *Lafferty*'s limited holding. To that end, we hold that a claim of negligence cannot sustain a deepening insolvency cause of action.").

103. *See id.* at 680 (rejecting extension of *Lafferty* beyond Pennsylvania).

104. *See id.* at 680 n.11 (limiting *Lafferty*'s holding to Pennsylvania).

105. *See id.* (describing ruling in *Oakwood Homes*, which held that deepening insolvency is cognizable cause of action under law of New York, Delaware and North Carolina). For a complete discussion of the facts of *Oakwood Homes*, see *infra* notes 114-16 and accompanying text.

dismantle the tort of deepening insolvency.[106] It is nevertheless significant, in its own right, to the development of deepening insolvency within the Third Circuit and more broadly to federal deepening insolvency jurisprudence in three ways.[107] First, by holding that deepening insolvency causes of action must be predicated on fraud, the *CitX* decision creates heightened procedural standards for plaintiffs to overcome when seeking to bring actions based on deepening insolvency.[108] Additionally, in refusing to recognize negligence as a basis for deepening insolvency, the decision provides assurance to corporate executives that good faith efforts to salvage distressed entities will not result in liability should the corporation reach insolvency.[109] Lastly, by rejecting deepening insolvency as a theory of damages and expressly limiting the *Lafferty* holding to matters governed by Pennsylvania law, the *CitX* decision signals the Third Circuit's growing reservations concerning deepening insolvency to lower courts in Pennsylvania and elsewhere within the Circuit.[110]

106. *See* Bondi v. Bank of Am. Corp. (*In re* Parmalat), 383 F. Supp. 2d 587, 602 (S.D.N.Y. 2005) (rejecting deepening insolvency under North Carolina law as duplicative of remedies for breach of fiduciary duty). The court declined "the invitation to recognize a novel tort duty giving rise to a novel cause of action under North Carolina law. North Carolina already imposes on every person a duty not to aid and abet a breach of fiduciary duty by another." *Id.* (refusing to recognize deepening insolvency); Alberts v. Tuft (*In re* Greater Se. Cmty. Hosp. Corp.), 333 B.R. 506, 517 (Bankr. D.D.C. 2005) ("The District of Columbia courts have not yet recognized a cause of action for deepening insolvency, and this court sees no reason why they should."). The Bankruptcy Court for the District of Columbia also noted the duplicative nature of deepening insolvency: "If officers and directors can be shown to have breached their fiduciary duties by deepening a corporation's insolvency, and the resulting injury to the corporation is cognizable, that injury is compensable on a claim for breach of fiduciary duty." *See id.* (quoting Bondi v. Bank of Am. Corp. (*In re* Parmalat), 383 F. Supp. 2d 587, 602 (S.D.N.Y. 2005)) (holding that breach of fiduciary claims are sufficient to remedy harm done to corporation through deepening insolvency); *accord* Official Comm. of Unsecured Creditors of VarTec Telecom, Inc. v. Rural Tel. Fin. Coop. (*In re* VarTec Telecom, Inc.), 335 B.R. 631, 644 (Bankr. N.D. Tex. 2005) ("[T]he Court finds that the Texas Supreme Court would not adopt 'deepening insolvency' as a separate tort, because the injury caused by the deepening of a corporation's insolvency is substantially duplicated by torts already established in Texas."); Kittay v. Atl. Bank of N.Y. (*In re* Global Serv. Group, LLC), 316 B.R. 451, 458-59 (Bankr. S.D.N.Y. 2004) (rejecting deepening insolvency as independent cause action and theory of damages). For a discussion of the *Global Service Group* ruling, see *supra* notes 69-77 and accompanying text.

107. For a complete discussion of the significance of *CitX* on deepening insolvency jurisprudence, see *infra* notes 108-32 and accompanying text.

108. *See CitX*, 448 F.3d at 680 (3d Cir. 2006) (rejecting negligence as basis for deepening insolvency claims). For a discussion of the heightened procedural standards that the fraud requirement creates for deepening insolvency, see *infra* notes 111-17 accompanying text.

109. For a complete discussion of *CitX*'s impact on corporate governance, see *infra* notes 118-23 and accompanying text.

110. *See CitX*, 448 F.3d at 677 (rejecting deepening insolvency as theory of damages). For a discussion on the expanding body of case law that has seized on *CitX*'s curtailment of deepening insolvency, see *infra* notes 124-32 and accompanying text.

A. *Fraud: An Additional Barrier in Asserting Deepening Insolvency Claims*

The *CitX* decision held that absent fraud, tort liability should not arise from efforts to extend the life of a corporation, even if those efforts result in the increased indebtedness of the enterprise.[111] By predicating deepening insolvency on fraudulent acts rather than mere negligence, *CitX* makes it much more difficult for a plaintiff to assert a claim for deepening insolvency.[112] Under this heightened standard, a plaintiff seemingly must prove the stringent fraud requirements in addition to the requisite damage to corporate property to successfully assert a claim for deepening insolvency.[113]

Although courts have different requirements for fraud claims, the *CitX* court approvingly cited the United States Bankruptcy Court's *Oakwood Homes* interpretation of what constituted fraud within the confines of *Lafferty*.[114] The *Oakwood Homes* ruling held that in order to prove fraud, a plaintiff must prove "a representation of material fact, falsity, scienter, reliance, and injury."[115] Should a plaintiff bring a deepening insolvency suit within a state that recognizes the tort as an independent cause of action, the plaintiff would have to prove all five elements of fraud, and presumably also prove "an injury to the debtor's corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life."[116] The extra hurdles *CitX* added to the pleading process have effec-

111. *See CitX*, 448 F.3d at 680 (rejecting negligence as basis for deepening insolvency claims in favor of standard that requires intentional action).

112. *See* Jo Ann Brighton, *The* Trenwick *Decision—The Death Knell for Deepening Insolvency? "Zone of Insolvency" Case Law Reigned In? Delaware State Court Says "No Action" for Deepening Insolvency in Delaware, but . . .*, 25-Oct AM. BANK. INST. J. 32, 33, 77-78 (2006) (explaining that added procedural barriers in asserting deepening insolvency cause of action have increased difficulty with which claim is pled).

113. *See id.* at 78 ("Even if the hurdle of getting recognition of a state law cause of action for deepening insolvency is cleared, the recent decisions of *CitX* and *Oakwood Homes* appear to require allegations of fraud in order to be successful.").

114. *See CitX*, 448 F.3d at 681 (citing *Oakwood Homes* as correct interpretation of fraud requirements). In *Oakwood Homes*, the court found that the plaintiff's allegations—specifically, that the debtor relied on lenders' misrepresentations about the solvency of a loan securitization program—were sufficient to prove fraud and support an action for deepening insolvency. *See* OHC Liquidation Trust v. Credit Suisse First Boston (*In re* Oakwood Homes Corp.), 340 B.R. 510, 514 (Bankr. D. Del. 2006) (stating factual background).

115. *See Oakwood Homes*, 340 B.R. at 534 (citing Vermeer Owners, Inc. v. Guterman, 585 N.E.2d 377, 378 (N.Y. 1991)) (noting five elements of fraud).

116. *See id.* at 534-35 (discussing appropriateness of application of fraud to deepening insolvency); *see also* Brighton, *supra* note 80, at 77-78 (indicating added requirements of deepening insolvency claims). One commentator has questioned the continuing utility of deepening insolvency claims and has stated that "it appears that a plaintiff asserting deepening insolvency as a cause of action must prove (1) fraud (with all five subparts), (2) that the fraud caused the expansion of corporate debt and (3) that the fraud also caused the prolongation of the corporations (pre-bankruptcy) life." *Id.* at 78 (illustrating challenges of asserting claims for deepening insolvency).

tively made it more difficult to assert a deepening insolvency cause of action than a fraud claim, which will undoubtedly result in the assertion of far fewer deepening insolvency causes of action.[117]

B. *Wide-Reaching Effects in the Board Room*

Beyond the additional procedural requirements that *CitX* places on deepening insolvency claims, the underlying holding in *CitX* reflects an acute understanding of the perils associated with the expansion of deepening insolvency to negligent acts.[118] By declining to extend deepening insolvency to mere negligence, the *CitX* court has enabled a board of directors to make reasonable business decisions on behalf of corporations with the assurance that decisions made in good faith will be shielded from liability by the business judgment rule.[119]

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117. *See* Brighton, *supra* note 80, at 68 (detailing added procedure plaintiffs face when asserting deepening insolvency claims instead of fraud claims). One commentator noted that "[t]he logical conclusion would be that plaintiffs would prefer not to take on these additional hurdles; therefore[,] deepening insolvency may not be included in complaints as an additional allegation with the same frequency in which it had been seen in the past few years." *See id.* (noting effects that *CitX* will likely have on number of deepening insolvency actions); *see also* Andre Tenzer, *Third Circuit Holds That Negligent Conduct Is Not a Basis for a Claim of Deepening Insolvency and Cautions Against a Broad Reading of Precedent Recognizing the Theory*, PRATT'S J. OF BANKR. L. 244 (Aug.-Sept. 2006), *available at* http://www.shearman.com/files/Publication/aa356955-1f77-4fa5-b3ae-3505de0a86e7/Presentation/PublicationAttachment/6f02e3d0-b29d-419e-a2bd-369e2d687670/BR_082006.pdf ("Perhaps the greatest beneficiaries of *CitX* will be outside professional advisors to bankrupt companies, against whom it will be more difficult to prove intentional misconduct and complicity in a fraud than presumably negligence or malpractice.").

118. *See* Harrell, *supra* note 4, at 175-76 (noting "slippery slope associated with burdening corporate directors with . . . potential liability"); *accord* Corporate Aviation Concepts, Inc. v. Multi-Serv. Aviation Corp., No. Civ.A. 03-3020, 2004 WL 1900001, at *4 (E.D. Pa. Aug. 25, 2004) (same); *Oakwood Homes*, 340 B.R. at 512 (upholding business judgment rule and holding that only fraudulent activities are sufficient to establish deepening insolvency claim). One commentator elaborated that extending deepening insolvency to claims of negligence "could provide a cause of action distinct from a breach of fiduciary duty claim, [and] officers and directors would be unable to rely on the protection of the business judgment rule." *See* Harrell, *supra* note 4, at 153 (detailing problems associated with extending deepening insolvency to negligent acts). *But see* Smith v. Arthur Andersen LLP, 421 F.3d 989, 995 (9th Cir. 2005) (ruling that deepening insolvency exists "when . . . the defendants 'misrepresent (not necessarily intentionally) the firm's financial condition to its outside directors and investors.'").

119. *See* Brian E. Greer, *Fiduciary Duties When the Corporation is in the Zone of Insolvency*, 25-Nov AM. BANKR. INST. J. 26, 57 (2006) ("Application of the business judgment rule will afford directors of troubled corporations the comfort to pursue value-maximizing strategies for the corporate enterprise as a whole, even if such a strategy includes the incurrence of additional debt obligations."); Rapisardi, *supra* note 1, at 1 ("The Third Circuit's ruling in *CitX* should afford directors of insolvent corporations more assurance that they will not be exposed to liability for deepening insolvency as long as they do not intentionally commit fraud or some other wrong.").

If the court in *CitX* upheld a negligence standard for deepening insolvency claims, it may have produced a de facto duty to liquidate in the face of insolvency.[120] Providing incentives for directors to immediately liquidate upon reaching insolvency rather than attempt to resuscitate corporations in an effort to maximize "long-term wealth creating capacity" contravenes public policy and lengthy judicial precedent.[121] Additionally, a contrary decision may have discouraged qualified members of the business community from accepting positions as directors out of fear of personal liability.[122] Ultimately, by rejecting negligence as a basis for deepening insolvency, the *CitX* court upheld the sensible penumbra of protection that the business judgment rule provides to corporate directors who act in good faith, with due care and in compliance with their fiduciary duties.[123]

C. *Impact on Lower Courts*

The Third Circuit decision in *CitX* represents one of the only appellate courts that, in the wake of the deepening insolvency hysteria, have begun to add structure to the fractured nature of deepening insolvency jurisprudence.[124] The *CitX* decision, which openly questioned lower courts' decisions to extend deepening insolvency beyond Pennsylvania and rejected deepening insolvency as a measure of damages, signified the Third Circuit's growing reluctance to recognize deepening insolvency claims.[125] Against this backdrop, several lower courts have, in rapid suc-

120. *See, e.g.*, Greer, *supra* note 119, at 58 (concluding that deepening insolvency has "constrained boards of corporations in the zone of insolvency from pursuing value-maximizing strategies for the corporation, which would benefit stockholders as well as creditors").

121. *See* Kittay v. Atl. Bank of N.Y. (*In re* Global Serv. Group, LLC), 316 B.R. 451, 460 (Bankr. S.D.N.Y. 2004) (ruling that "[t]he fiduciaries of an insolvent business might well conclude that the company should continue to operate in order to maximize" its value). The court held that "there is no absolute duty under American law to shut down and liquidate an insolvent corporation. The fiduciaries may, consistent with the business judgment rule, continue to operate the corporation's business." *Id.* (explaining holding that insolvent corporation, to maximize value to stakeholders, may continue to operate and not simply liquidate).

122. *See* Harrell, *supra* note 4, at 152 ("[I]f courts extend the deepening insolvency theory to include negligent decisions in the face of insolvency, thereby ignoring the business judgment presumption, the best and brightest will likely decline these positions due to the increased potential for personal liability.").

123. *See* Seitz v. Detweiler, Hershey & Assoc., P.C. (*In re* CitX Corp.), 448 F.3d 672, 681 (3d Cir. 2006) (holding that "a claim of negligence cannot sustain a deepening-insolvency cause of action"). For a complete discussion of the court's holding in *CitX*, see *supra* notes 78-105 and accompanying text.

124. *See CitX*, 448 F.3d at 677-78, 680-81 (rejecting deepening insolvency claims based on negligence and limiting *Lafferty*'s precedential value to courts within Pennsylvania).

125. For a complete discussion of the court's decision to rein in deepening insolvency, see *supra* notes 78-105 and accompanying text.

cession, utilized the *CitX* holding to rule against plaintiffs seeking to assert deepening insolvency causes of action.[126]

A decision by the highly influential Delaware Court of Chancery in *Trenwick America Litigation Trust v. Ernst & Young* is particularly noteworthy because the court expanded on the trepidations manifested in *CitX* to definitively reject deepening insolvency as an independent cause of action in Delaware.[127] The court, stressing the protection the business judgment rule provides to directors and other fiduciaries, stated that "the words 'zone of insolvency' should not declare open season on corporate fiduciaries."[128] The *Trenwick* decision reflects the underlying concerns that many lower courts began to recognize with deepening insolvency claims.[129]

126. *See, e.g.*, Official Comm. of Unsecured Creditors of Allegheny Health, Educ. and Research Found. v. Pricewaterhouse Coopers, LLP, NO. 2:00CV684, 2007 WL 141059, at *5 (W.D. Pa. Jan 17, 2007) (ruling that after *CitX* negligence cannot sustain deepening insolvency cause of action); Official Comm. of Unsecured Creditors of Radnor Holdings Corp. v. Tennenbaum Capital Ptnrs., LLC (*In re* Radnor Holdings Corp.), 353 B.R. 820, 842 (Bankr. D. Del. 2006) (ruling that Third Circuit decision in *CitX* precludes plaintiff from sustaining independent deepening insolvency claim or utilizing deepening insolvency as proper measure of damages); Official Comm. of Unsecured Creditors of Verestar, Inc. v. Am. Tower Corp. (*In re* Verestar, Inc.), 343 B.R. 444, 476 (Bankr. S.D.N.Y. 2006) (rejecting plaintiff's deepening insolvency claim based on *CitX* ruling and holding that "to the extent a plaintiff asserts that a director harmed creditors solely by permitting the corporation to remain in business and incur 'unnecessary' debt, and alleges no more, the charge must relate to a breach of the duty of care"); Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 207 (Del. Ch. 2006) (utilizing *CitX* ruling to reject deepening insolvency claim). *But see* Alberts v. Tuft (*In re* Greater Se. Cmty. Hosp. Corp.), 353 B.R. 324, 337 (Bankr. D.D.C. 2006) ("The court is . . . unmoved by the Third Circuit's decision to restrict recoveries for deepening insolvency to actions involving fraud.").

127. *See Trenwick*, 906 A.2d at 174 ("Put simply, under Delaware law, 'deepening insolvency' is no more of a cause of action when a firm is insolvent than a cause of action for 'shallowing profitability' would be when a firm is solvent."). *But see In re* Fleming Packaging Corp., No. 03-82408, 2006 WL 2587916, at *5 (Bankr. C.D. Ill. Sept. 8, 2006) (holding that it is "open question whether Delaware will recognize a separate cause of action for deepening insolvency" because "[o]nly the Delaware Supreme Court [and not the Chancery Court] may speak definitively on this issue"). Insofar as the Delaware Supreme Court has not yet addressed this issue, federal courts are not bound to apply either decision, but may use intermediate courts to help guide their ruling. *See* Paolella v. Browning-Ferris, Inc., 158 F.3d 183, 189 (3d Cir. 1998) (holding that federal courts "may also consider the decisions of state intermediate appellate courts in order to facilitate [their] prediction"); Orson, Inc. v. Miramax Film Corp., 79 F.3d 1358, 1373 n.15 (3d Cir. 1996) (holding that "[w]hen the state's highest court has not addressed the precise question presented, a federal court must predict how the state's highest court would resolve the issue").

128. *See Trenwick*, 906 A.2d at 174 (upholding applicability of business judgment rule to deepening insolvency claims asserted within Delaware).

129. *See, e.g.*, Bondi v. Bank of Am. Corp. (*In re* Parmalat), 383 F. Supp. 2d 587, 591 (S.D.N.Y. 2005) (noting that, under North Carolina law, if corporate officers and directors breach their fiduciary duties by increasing corporation's insolvency, such injury is 'compensable,' but not under theory of deepening insolvency); *Alberts*, 333 B.R. at 517 ("The District of Columbia courts have not yet recognized a cause of action for deepening insolvency. There is no point in recog-

Namely, suits asserted under deepening insolvency are duplicative in nature and other causes of action, such as breach of fiduciary duty and fraud, sufficiently address and provide remedies for fraudulent acts committed by boards of directors of insolvent corporations.[130]

In the aftermath of *CitX* and its progeny, some commentators have begun to question whether the tort of deepening insolvency has any "continuing utility" or whether it has "merely become an 'add on' to fraud counts in complaints."[131] The combined force of *CitX* and the growing number of state courts that have refused to recognize deepening insolvency as an independent cause of action will likely deter future plaintiffs from asserting claims based solely on deepening insolvency.[132]

V. THE END OF DEEPENING INSOLVENCY?

Five years ago, trustees' and creditors' committees seemed poised to plunder the deep pockets of corporations' auditors, directors and lenders under an emerging theory of liability known as deepening insolvency.[133] In its recent *CitX* decision, the Third Circuit drastically narrowed the misguided expansion of deepening insolvency by predicating deepening insolvency on fraud, emphatically rejecting deepening insolvency as a measure of damages and limiting the precedential scope of *Lafferty* to

nizing and adjudicating 'new' causes of action when established ones cover the same ground."); Official Comm. of Unsecured Creditors of VarTec Telecom, Inc. v. Rural Tel. Fin. Coop. (*In re* VarTec Telecom, Inc.), 335 B.R. 631, 644 (Bankr. N.D. Tex. 2005) (holding that deepening insolvency is substantially duplicated by torts already established in Texas).

130. *See Trenwick*, 906 A.2d at 175 (holding that other causes of action addressed deepening insolvency claims). The court emphatically ruled that "if the board of an insolvent corporation acting with due diligence and good faith, pursues a business strategy that it believes will increase the corporation's value," but nevertheless involves securing additional debt, "it does not become a guarantor of that strategy's success." *See id.* (upholding reasoning behind business judgment rule). Rather, the board is protected by the business judgment rule. *See id.* (same). The *VarTec* court also discussed the duplicative nature of deepening insolvency, holding that established torts in Texas sufficiently address any harm that may have occurred. *See VarTec Telecom*, 335 B.R. 631, 644 (Bankr. N.D. Tex. 2005) (noting duplicative nature of deepening insolvency).

131. *See* Brighton, *supra* note 112, at 77-78 (questioning whether deepening insolvency has any remaining viable purpose); *see also* Gordon, *supra* note 41, at 234 ("[T]here are few, if any, instances where deepening insolvency alone may be applicable to the exclusion of claims for fraud or breach of fiduciary duty. This . . . begs the question of whether there is any need for states to recognize a deepening insolvency cause of action at all."); John J. Rapisardi, *Delaware Court Rejects 'Deepening Insolvency' Theory*, N.Y.L.J., Sept. 29, 2006, at 3, 5 (2006) (asserting that *CitX* "may have eliminated the efficacy of deepening insolvency as an independent cause of action by limiting its availability to situations in which it would be redundant to other causes of action, such as fraud").

132. *See* Brighton, *supra* note 80, at 69 (concluding that *CitX* and lower court's rulings have made deepening insolvency causes of action much more difficult to assert and maintain).

133. For a discussion of the early development of deepening insolvency, see *supra* notes 21-41 and accompanying text.

Pennsylvania.[134] *CitX*'s rejection of a negligence standard for deepening insolvency has created new heightened procedural obstacles that markedly increase the difficulty with which plaintiffs assert such claims.[135] Additionally, *CitX*'s palpable disdain for deepening insolvency has spawned a line of cases that severely curtail the tort by rejecting it as an independent cause of action, finding instead that other causes of action based largely on pre-existing duties are the appropriate means by which to assert a claim.[136] This growing trend is unlikely to subside in the near future and has made deepening insolvency claims increasingly difficult (and in some cases entirely impossible) to assert as a valid and independent claim.[137] The *CitX* ruling prudently upheld the applicability of the business judgment rule in the zone of insolvency, which will undeniably increase directors' willingness to salvage distressed entities through the reduced likelihood of personal liability.[138] Ultimately, the Third Circuit's decision in *CitX* is good news for corporate directors, lenders and auditors, who can now breathe a collective sigh of relief that long overdue common sense has been infused into deepening insolvency jurisprudence.[139]

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134. *See* Seitz v. Detweiler, Hershey & Assoc., P.C. (*In re* CitX Corp.), 448 F.3d 672, 677, 681-82, 681 n.11 (3d Cir. 2006) (limiting deepening insolvency). For a discussion of the *CitX* ruling, see *supra* notes 78-105 and accompanying text. For a complete discussion of the effects of the limitations that *CitX* placed on deepening insolvency, and the unmistakable trend in lower courts towards rejecting deepening insolvency as an independent cause of action, see *supra* notes 106-32 and accompanying text.

135. For a discussion of the added procedural barriers for plaintiffs seeking to assert deepening insolvency, see *supra* notes 111-17 and accompanying text.

136. For a discussion of courts that have rejected deepening insolvency and instead have held that other causes of actions are the appropriate means to assert these claims, see *supra* notes 124-32 and accompanying text.

137. *See* Brighton, *supra* note 112, at 76-79 (concluding that *CitX* and *Trenwick* "may have rung the death knell for claims of deepening insolvency"). For a complete discussion of the jurisdictions that have rejected deepening insolvency as an independent cause of action in the wake of *CitX*, see *supra* note 126 and accompanying text.

138. For a thorough analysis of the *CitX* court's rejection of negligence as a basis for deepening insolvency and its impact on the business judgment rule, see *supra* notes 118-23 and accompanying text.

139. For a discussion of the wide-reaching positive impact of *CitX* on lenders, directors and auditors, see *supra* notes 106-32 and accompanying text.